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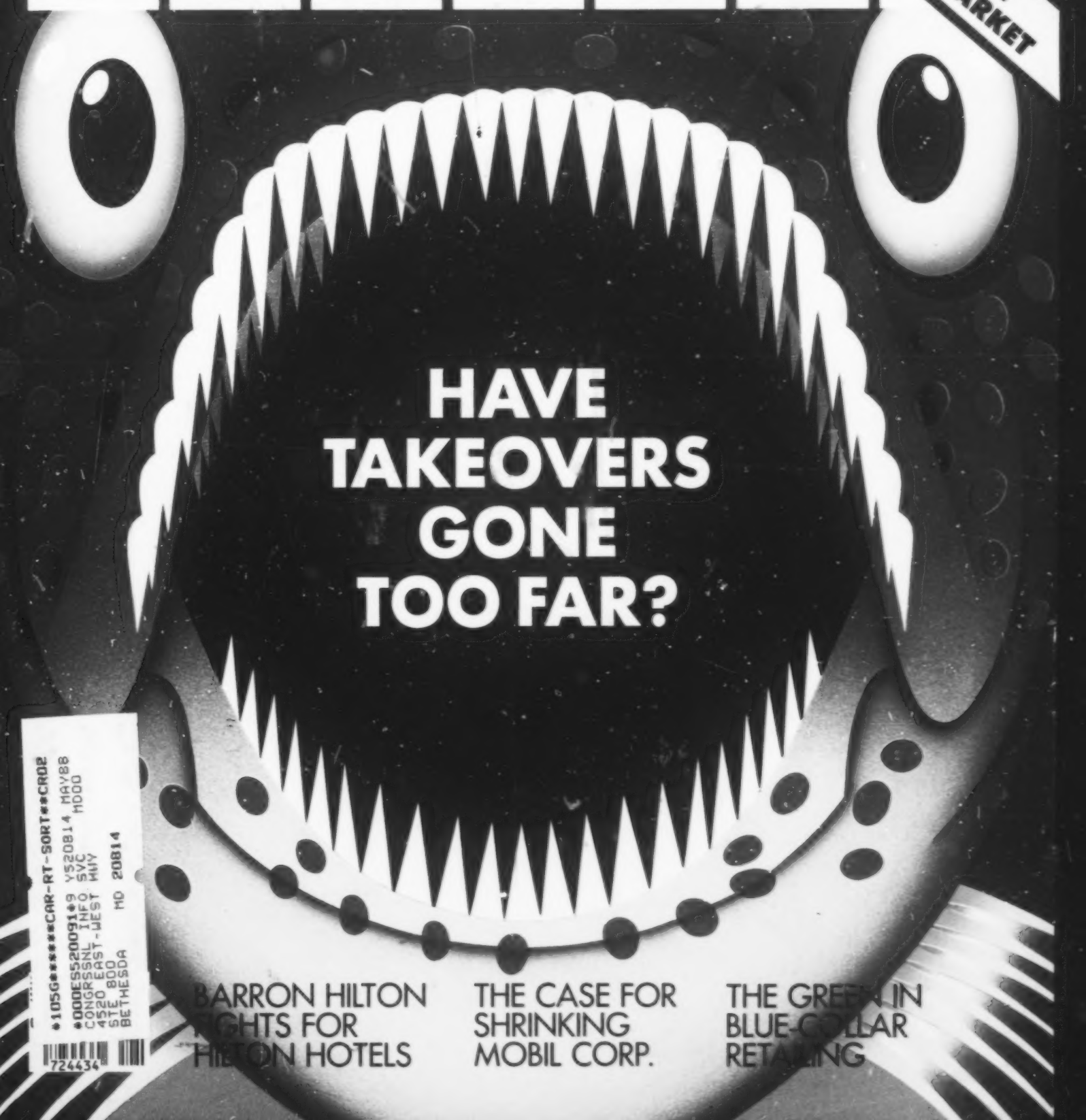

HAVE TAKEOVERS GONE TOO FAR?

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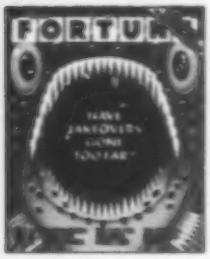

In Nicholas Gaetano's cover painting, corporate predation is fiercer than ever. *See page 20.*

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HAVE TAKEOVERS GONE TOO FAR?

Even giant corporations feel vulnerable to raiders these days, and a lot of managements would feel more comfortable if the government would raise new bars to unfriendly acquisitions. But intervention would be bad for stockholders and the economy. ■ *by Aloysius Ehrbar*

HOSTILE TAKEOVERS, always a subject of high contention, have become one of the hottest issues in Washington, on Wall Street, and in boardrooms across the U.S. Corporate chieftains, lawyers, investment bankers, Senators, and Congressmen are crying out more loudly than ever about the rapacity of professional raiders. Their complaints: Takeover mania wastes scarce investment capital. It inhibits innovation and threatens the competitiveness of U.S. industry by forcing managers to sacrifice long-term growth for transitory, short-term profits. The raiders dismember venerable corporations, destroying jobs and disrupting communities. And they saddle surviving companies with dangerously high leverage.

Have hostile takeovers gone too far? In five words, yes and no—mostly no. There have been excesses on both sides of the corporate barricades as takeover activity heated up over the past 18 months or so. But while the excesses are deplorable, they are probably self-correcting. The takeover explosion as a whole, on the other hand, has much to be said for it. Disinflation, deregulation, more sensible antitrust enforcement, and the virtual collapse of OPEC have left companies and whole industries in need of restructuring. In many cases assets and strategies that were right for the late 1970s are inappropriate for the mid-1980s. While raiders may intend only to enrich themselves, in some instances they also accelerate needed change by bidding for control of corporations whose managers are adjusting too slowly to the new environment. And the competition for corporate control pushes all managers to exploit their assets more efficiently.

Certainly both raiders and managers of target companies have gone to extremes in trying to tilt the odds in their favor. One unseemly tactic is greenmail, wherein a raider accepts a payoff from a target company, in the form of an above-market price for his shares, in return for walking away. Managers of target companies pay greenmail with company funds—that is, with money that other shareholders would prefer to see used differently. Another weapon not necessarily to the liking of every shareholder is the poison pill, a dastardly device that makes hostile takeovers deathly expensive.

Though they shouldn't exist, neither greenmail nor poison pills seem so grievous as to require intervention by Congress. Managers are learning that paying greenmail to one raider often attracts another. Outraged institutional investors are voting against poison-pill proposals in proxy statements and raiders are challenging them in the courts. Some investment bankers predict that neither will be important in the takeover game much longer.

The constant threat of a hostile tender offer provides managers with plenty of incentive to want raiders put out of business. Sympathetic legislators have introduced a blizzard of bills aimed at taming the takeover menace. Republican Pete Domenici, chairman of the Senate Budget Committee, proposed a temporary ban on takeovers financed with junk bonds—debt securities that are unrated or rated lower than Ba by Moody's and BBB by Standard & Poor's, and that pay interest rates three to five percentage points higher than investment-grade bonds because they are higher risk. Domenici's bill would affect only hostile acquisitions; it would still permit the use of junk bonds in leveraged buyouts and acquisitions that have the blessing of the acquired company's directors. Democrat Peter Rodino, chairman of the House Judiciary Committee, introduced a bill that would require disclosure of the social ramifications of takeovers—a sort of environmental impact statement for raiders. Senator William Proxmire advocates new rules that would all but eliminate acquisitions that aren't endorsed by the target company's directors; he calls his plan the Corporate Productivity Act of 1985.

Meanwhile, the raiders snap at their prey like a school of bluefish in a feeding frenzy. T. Boone Pickens, his checking account fat with pelf from forays against Gulf Oil and Phillips Petroleum, is mounting an assault on Unocal, the nation's 13th-largest oil company. Carl Icahn, scarcely pausing to digest *his* profits from tormenting Phillips (Icahn took a bite after Pickens was done), is making a hostile run at Uniroyal. Anglo-French financier Sir James Goldsmith, fresh from lucrative raids on St. Regis Paper and the Continental Group, is battling for Crown Zellerbach while simultaneously amassing shares in Colgate-Palmolive. And "Terrible" Ted Turner, the "Mouth of the South," is making an audacious no-cash offer for CBS, a company he once called "a cheap whorehouse."

THE NEW WORRIES about raiders stem from dramatic changes in the takeover game. The raiders in the biggest takeovers used to be chief executives of large corporations, such as Harry Gray of United Technologies, who stalked targets that they wanted to fold into their operations. But the raiders in the largest and most dramatic recent battles have been financial opportunists like Pickens, Icahn, and Goldsmith. Their companies, often just paper vehicles set up to mount takeovers, usu-

RESEARCH ASSOCIATE *Lorraine Carson*

ally are puny compared with the targets. These raiders are rarely after companies they want to own. They may want to keep part of a target, but they're mostly interested in selling off pieces for more than the values they command in the stock market. Which means that they might spring on any company they believe is undervalued.

Today's raiders owe much of their muscle to Drexel Burnham Lambert, the investment banking firm that devised the junk bond financing method they use to raise funds for tender offers. Michael Milken, 39, a brilliant trader who led Drexel to dominance of the junk bond market during the 1970s, pioneered the original issuance of high-yield securities. Hardly any companies issued junk bonds 15 years ago; most of the ones on the market had been issued as investment-grade securities by blue-chip companies that had fallen on hard times. Last year corporations issued $14 billion of junk bonds, $10.3 billion of them through Drexel. Only about 10% of Drexel's issues went for leveraged buyouts and takeovers, both hostile and friendly. At the end of 1981 Drexel began selling junk bonds to finance leveraged buyouts. From there it was a simple step to using them to bankroll hostile takeovers as well (FORTUNE, September 3, 1984).

Junk bond takeover financing makes the largest companies vulnerable to the puniest raiders. It also is a cheap source of financing because Drexel doesn't actually raise the money backing up the tender offers. Instead, it lines up commitments from institutional investors to buy the bonds if the tender offer succeeds. The institutions promise to put up the money in return for commitment fees that range from 0.35% to 0.70% of the amount they pledge, or $35,000 to $70,000 for a $10-million commitment.

Boone Pickens was the first to use junk bonds in a takeover attempt when he went after Gulf Oil in 1983. Ever since, financial speculators have scurried to Drexel. Milken arranged junk bond commitments for Goldsmith's tender offer for the Continental Group last year. Icahn relied on Drexel-generated commitments to give credibility to his $4-billion offer for 51% of Phillips. Pickens has commitments of $3 billion arranged through Drexel behind his offer for Unocal.

Drexel's actions have bolstered the impression that the takeover process can't possibly produce anything good for the economy. The investment bankers at Drexel search out companies that could be carved up for more than their stock market values, and then look for a raider to make the move. For instance, Drexel thought Phillips was still vulnerable after it bought out Pickens, and sold Icahn on making his bid. That ambulance-chasing approach to investment banking isn't new. Investment banker Felix Rohatyn, an archcritic of the current scene, has been proposing takeovers to clients for decades. But Drexel's fee in the Icahn-Phillips deal was somewhat unusual; it got 20% of Icahn's profits. That seemed to make Drexel as much a partner as an adviser to Icahn.

Have Junk, Will Travel

Corporate raiders retrenched during the stock market rally of 1982 and 1983, but junk bond financing set them in motion in 1984.

That's not how white-shoe investment bankers used to behave.

Though they're hired by the board of directors on behalf of the shareholders, the investment bankers who defend corporations against takeovers don't always seem to represent the shareholders' interests. The directors of Phillips agreed to pay their investment bankers, Morgan Stanley and First Boston, up to $35 million if they defeated Boone Pickens but only $6 million if they lost. In the Pickens-Unocal contest, Morgan Stanley and Dillon Read will split $25 million in fees if Unocal remains independent. If the company is acquired by anyone, at any price, they'll get $5 million less. Payments like those give the investment bankers considerable incentive to help managers keep their jobs while distancing the bankers' interests from those of the shareholders.

Takeover critics maintain that this "junk bond takeover binge," as Nicholas J. Brady, the chairman of Dillon Read, calls it, is leading to the overleveraging of America. The warnings about excessive leverage sound persuasive: many junk bond takeover bids would result in companies with just a whisper of equity and a roar of debt. And plenty of sensible people have worried about the inherent risk in recent leveraged buyouts. Preston Martin, vice chairman of the Federal Reserve, says that he is "especially concerned about financial risks involved with leveraging and with acquisition activity financed with large amounts of debt."

Leveraged buyouts, however, aren't what the antitakeover folks are trying to halt. Nor has much been heard about the leverage taken on to finance friendly acquisitions. The calls for action apply only to junk bonds used in hostile takeovers. But not one junk-bond-backed takeover bid last year ended with the bonds actually being issued—Coastal States raised $300 million through Drexel to help finance its $2.2-billion acquisition of ANR. Every other junk bond takeover target either paid greenmail, driving the raider away, or was acquired by another bidder.

Many managers complain that the threat of hostile tender offers pressures them to prop up short-term earnings to raise their stock price and make the company unattractive to raiders. Says William C. Norris, chief executive of Control Data: "As companies strive to avoid becoming targets—to push share prices continually upward—management attention is riveted to short-term results." They could hype short-term earnings by cutting back on capital investment and research and development. But there is little convincing evidence that fear of takeovers has in fact caused large numbers of companies to slight future growth for the sake of short-run profits.

A high stock price plainly is the best defense against a takeover. Raiders only want companies whose stocks sell at deep discounts to the value of the underlying assets. But managers who scrimp on capital spending and R&D in order to boost short-run earnings are likely to push their stock price down, not up. The notion that the way to lift your stock price is to pump up short-term profits by skipping attractive long-term investments assumes that the market systematically undervalues future earnings. Or, as Joseph R. Perella, co-director of mergers and acquisitions at the investment bank of First Boston, puts it: "The whole short-run argument is based on the supposition that you maximize your share price by maximizing quarterly earnings. Where is that written?"

The best available evidence suggests that the stock market pays pretty close attention

Setting big oil, *John Scott of Drexel Burnham Lambert meets with his oil and gas group to plot strategy in Boone Pickens's raid on Unocal.*

to actions that affect future earnings. For instance, shifting inventory accounting from first in, first out to last in, first out depresses current earnings but also reduces taxes and increases long-run earnings. If investors took only the short-run view, stock prices should drop when companies shift to LIFO. But studies found that stock prices don't drop; if anything, they rise.

THE STOCK MARKET apparently takes a long-run view of capital expenditures and investments in R&D too. While these may reduce short-run profits, the market likes them. Economists at the SEC measured the market's reaction to 62 announcements of new R&D projects from 1973 to 1983. On average, the stocks of the companies involved rose 1.8% (adjusted for movements in the overall market) in the four weeks after the announcements.

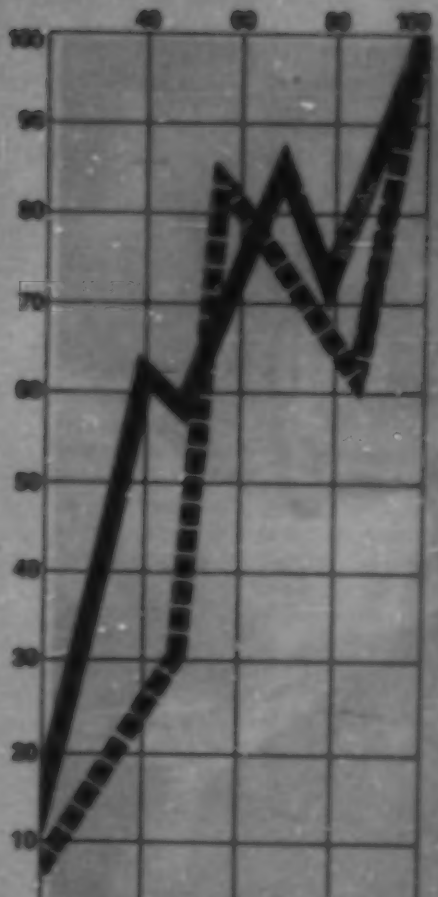
Two financial economists, John J. McConnell of Purdue University and Chris J. Muscarella of Southern Methodist University, made a similar study of the response to changes in capital budgets from 1975 through 1981. They found that stock prices rose when companies announced increases in capital budgets and dropped when companies cut their capital budgets.

Investors also seem smart enough to judge the wisdom of the investments. A major exception is McConnell's and Muscarella's findings involved oil companies. Their stocks dropped when they announced increased outlays for exploration and development and rose when investment was cut back. Michael C. Jensen, a finance professor at the University of Rochester, says that result supports his theory of why oil stocks have been selling at large discounts to their underlying values. The industry has had surplus capacity ever since the embargo in 1974, Jensen says, yet most major oil companies have been wasting money on too much exploration and too many refineries. He argues that the best long-term course for the companies is to postpone exploration until capacity declines.

That may explain why the stock market reacted so favorably to Arco's April 29 announcement that it was selling 1,147 gasoline stations in the Northeast, selling a refinery in Philadelphia, and cutting its exploration budget from $3.6 billion to $2.8 billion (see Corporate Performance). Arco said the moves would require a $1.3-billion write-off this year, and yet its stock jumped 18% in five days. Brady of Dillon Read says Arco is sacrificing its long-run interests to keep raiders away. Jensen voices the polar view that fear of raiders helped persuade Arco to take the course that should be most profitable in the long run.

Another charge leveled against takeovers is that they soak up scarce credit that ought to be used for productive investments. But the money that raiders or other acquirers pay for companies goes to shareholders, few of whom, it seems safe to assume, tuck it under their mattresses. The only money that moves out of the savings pool is what individual shareholders spend on consumption, and even that stimulates the economy and ultimately leads to investment.

Critics also worry about dismembering corporations. Nicholas Brady states the case this way: "Busting up corporations for the sake of a few extra dollars for shareholders is a very short-term view. We ought to be a little careful in allowing a system that dis-



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A junk bond pioneer, Michael Milken of Drexel Burnham set up today's tender offers.

members corporations." That complaint is based on the belief that corporations are responsible not only to shareholders but also to many other "stakeholders," including employees, suppliers, and consumers.

But breaking up a company does not destroy its assets; it simply moves the assets to *new* users who think they can use them *more productively* and therefore are willing to pay a higher price for them. Acquirers have no monopoly on busting up companies; many corporations sell subsidiaries to other companies or spin off divisions in leveraged buyouts. In either case, the managers may be right or wrong. But the actions are often interpreted differently, depending on who is doing the dismembering. When, say, ITT sells off acquisitions that didn't work out, it tends to get applauded for making sensible divestitures. When a raider sells a division of a target he has taken over, he usually gets damned for busting up the company.

Takeovers can be wrenching for the communities left behind, especially the employees. But there is little evidence that hostile acquirers treat employees, suppliers, or customers any worse than the old managers did or friendly acquirers would. After all, whoever ends up operating the company ought to have as much incentive as his predecessor to keep employees sufficiently happy to run a good business. Few executives would argue that Congress should block all mergers, acquisitions, and sales of factories or divisions; they recognize that the transfer of assets is essential in a dynamic economy.

The special danger in the current phase of the takeover game is that Congress might enact legislation that impedes hostile tender offers. Peretz of First Boston says: "Congressmen don't understand the takeover game. But they have to get reelected and they need campaign contributions, and they understand that game very well." The test for judging takeovers should be whether both raiders and existing management treat shareholders fairly. A free, fluid market for corporate control is an essential ingredient of a sound economy. Any additional limits on takeovers would simply lock up assets in inefficient uses and do exactly what the anti-takeover forces say they fear—frustrate innovation, reduce competitiveness, and lead to a lower standard of living. ■